Microsoft – Puerto Rico Cost Sharing Structure
4/1/2005 8:01 AM

KPMG - Brett Weaver, Dick Boiken, Manal Corwin, Greg George, Anne Welsh, Brian Burt, and David Unger

Microsoft - David Gunther, Glen Cogswell (Director of International Tax), Nancy Perks, Tracy Neighbors, Tom Sullivan, Susan McGregor, Trudy Ide, Tom Sullivan, Glen Elmburg, Susan McGregor, Bruce ?, Lance Behnke, and John Peterson (Baker & MacKenszie)

Kick-Off meeting began at 4/1/2005 9:03 AM

Overview – Glenn Cogswell

MS operates a 936 regime in PR, producing 50-60% (in dollar terms) of the CDs for the Americas (in US, CAN, LA). CDs for Full Package Product. Enterprise customers also receive some of these.

CDS are shipped to 3rd party vendors, and Corp pays for them to be packaged and distributed.

New system is ramped up, hopefully to 100%. 2% Income Tax on CD/DVD production, and tax deferral. All CD s will still come to the US and be sold on to customers.

What happens when all info sent online? Will be able to get the deferral? Yes because customers seem to want CDs, and we'll put the servers down in PR and send them CDs too.

Discussion as to if there is actually more than 1% of customers who are taking software by line (electronic delivery).

Approximately 10billion in revenue will run through this project.

Cash savings and cash flow discussed. Break-even situation discussed with regard to "Estimated cash tax benefits and operations cost over a ten year period" slide. There cannot be a loss that is material from a GAAP standpoint in any of the years.

Assumptions on model: 4.5-year life, 6-month lag. 65/45 split. GAAP we use 6-year life. In year 13, savings realized. PR has no intangibles down there now. They will buy into technology piece. They'll never own marketing intangibles. Models are conservative. Buy-in calculation based on residual profit split: 55% Technology, 45% Marketing. All technology shifted to PR, and all marketing profits remain in the US. Also trying to acquire new piece of land and getting operations in place by 7/1/06, so that they can handle 100% of capacity.

Government Exhibit
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We want to beat the regs, so the sooner we get the structures in place the better.

Proposed legal structure: pictured at end of document.

Product flow does not change. Only structure of IP ownership will be altered. Customers should not experience any change in flow.

Tasks discussed. 100% production needed. Relationship maintained with 3rd party vendor in case of catastrophe. Microsoft Caribbean will still be separate. Product sales will mean MSLI product sales booked to corporate. There is NO contract between 3rd party vendor and PR. PR will have two customers: MSLI and MS Corp. Nothing changes.

Prior cost-share arrangements – discussed by Gunther. Economic life and depreciation assumptions are discussed.

May 99 – EMEA retail buy-in (very granular model), EMEA OEM buy-in, and then APAC Retail. In EMEA, there was a Tech/marketing split of 59/41. In EMEA OEM 56/44, and in APAC, 70/30 (all projected) but as a look back these turned out as 55/45, 58/42, and 69/31, respectively. We don't invest as heavily in marketing in Asia, so that may explain the difference in the relative spend. Worth discussing in terms of PR.

In PR model, we haven't yet discussed the decline in rates, but if we had done a level rate then it would have been EMEA retail buy-in (9%), EMEA OEM buy-in (15%), and then APAC Retail (29%).

Level of Granularity : EMEA retail buy-in (Channels include FPP, Select, Open, MLP, Enterprise and Other), EMEA OEM buy-in (Including System builder), and then APAC Retail (Includes only Combined Channels). FYEO document – returned to client for shredding.

A lower technology number was a conservative estimate (Welsh). If in actuality we are very conservative, break-even might be later if technology is a larger number.

Discussion of new structure: see attached

From a federal tax perspective, are there questions about the cost share and the new C-Corp Co. In the old structure, because of check the box, it was cost-sharing, in the structure.

Functions/new employees and land in PR (in preference to Bermuda). When PR pays it first buy-in payment, where does it get its money? Initial capital input for land, then don't worry about long term loan servicing. Long-term capital will not be a problem. Stick in a cash center? Right from the beginning, use a MGFL? The way the grant works, there is no withholding on either side.

Peterson: Put in the 50 million for the facility.

Current PR has 500 Mill in cash that needs to be there 6 more years to avoid W/H taxes.

Weaver: Enter into this cost sharing arrangement now and also take the 936 credit through fiscal 06. Set up new structure today but contract with old company .

Shares from HOLDCO to NEWMSPR and then cease operations on OLDMSPR. If cash is repatriated back from OLD MSPR, it would trigger 10% withholding tax. Glen would like MSPR 936 to wrap up on its own rather than try to trade shares, owing to the way in which PR Gov deals with audits.

Peterson: hold off on formation of HOLD CO, insert it later, and get 351 and 367 in PR, as acknowledged by IRS.

Treasury wants cash back from OLD MSPR. During ramp up phase, double dip. We want to do something now to get this going. The base line of what we'll do to get things going, use capacity of existing MSPR, sell to NEW PRCO, which in turn enters into Cost sharing with Corp and EMEA. That will be the full marked up price. It will CD from MSPr to New PRCO will be cost-plus price. Benefit cap coming out of the profit from Corp on the marketing side. MSCORP's profit reduced by the higher cogs coming out of PRCO.

All the manufacturing margin (residual profit) goes to the company in the middle, PRCO. Those profits get washed out. Is that remaining profit enough to get us to our cap? Glen thinks it is if PRCO ramps up. Want to get this done before the new regs (but with no Assistant Sec for Tax Policy, unlikely that they'll come out by June. Don't bank on it before June for a project like this.) New regs may appear before the June Business plan year end. Do we sign the agreement, and start cost-structure, but don't create any other function? Or just sign the agreement? Do some economic analysis for one month of cost sharing payments?

Common for companies to cost-share before they begin production. Do the cost share and hold off on the buy-in? IN effect, start cost-sharing for new technology, but not yet sharing in the old technology, except for the use of it to create new technology. (Peterson) On the first day of the Cost sharing agreement, we set a price, but do we have that take into account the fact that they aren't selling anything yet. What's the right price?

Weaver: if this is an unconditional transfer then no problem, as these are just payment terms. But if there is a contingency in there, then price must reflect that.

So we have to define the pool issue, the scope of the IP transfer (this is a big job). What that really means is that we have to describe it in a legal agreement. Do we want to derive the cost share payment through the ratio, or do we want to exclude certain IP from that ratio. We have to make that decision before you sign the agreement.

Nancy: You are focusing on the net present value of the buy-in payment.

If your cost share is based on your expected future benefit, then the fact that you can't share in the sales of the company should be taken into account in calculating that EFB. Will PRCO get the benefit of the research done today? The argument is that it would. It will be pretty close to 100% (Peterson).

If you structure it so that you purchase 100%, and only get 60%, what happens to the 40%? There is a separate rights transfer. If you are ramping up later, it is pursuant to the later buy in, and you've bifurcated the payment, if the right doesn't exist from corp in the first place. You could have MS Corp top up what PRCO produces until PRCO has total capacity but have we created a need for a royalty.

Weaver: Two goals for this structure - We are trying to 1: Avoid an agreement that has contingency system. And 2: We are looking at the economics, such that the payments match the economic reality of the risks borne.

In the first year of the cost-sharing payment, we won't be negative, but in the second year, we might be, so that is all we have to worry about.

Over time, we can begin moving all the contracts down to PR. These vendor contracts are all 1-year deals which are terminable.

If you can't move the vendor contracts, then you have to deal with ECI, but in the short term, only a few can be moved. Senior management has signed up to this on the basis that there is no tax benefit to this for 6 years that this is invisible to 3rd parties, and that in 6 years time we are still selling software on media, even though there's doubt that we will do that. If this fact pattern does not agree with what is going to happen, then there is little value to this structure.

Americas region run out of Ft. Lauderdale. Might be able to leverage out of that for the basis of a PR office to manage relationship with Corp.

We've given up 15 months of the grant so this could be implemented early; 15 year grants.

From an agreement validity point of view, the numbers don't mean as much as having real validity in place for the deal.

Business risk is high if we cannot fulfill the demand as planned. This will be the largest media processing plants in the world.

On Agreements: if you could just ramp up production, Vendor Contracts wouldn't have to be changed? (Weaver)

Break at 4/1/2005 12:05 PM

Discussion of timing and work plan.

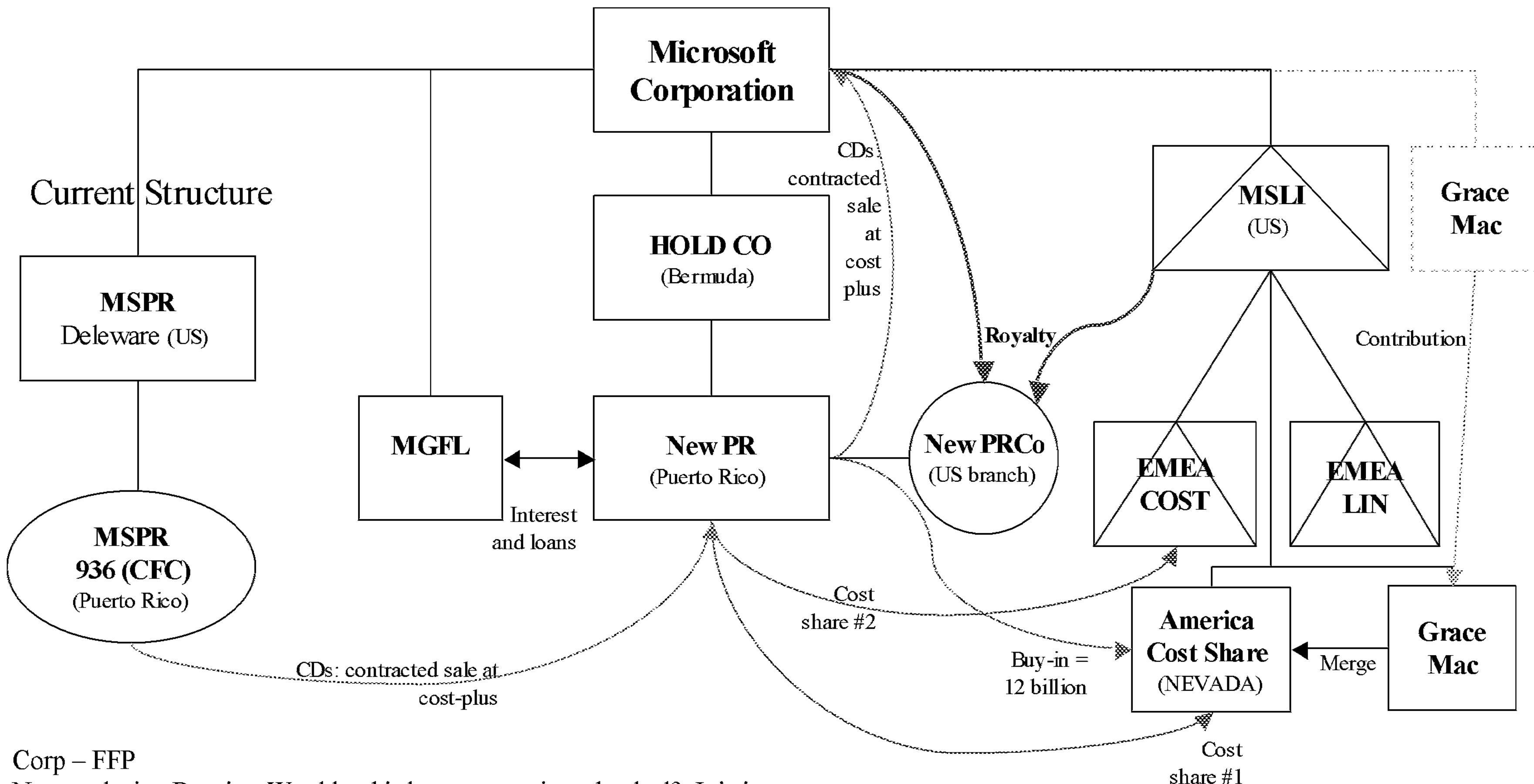
Safety stock discussion: Safety stock will be charged at cost and held. If stock is lost, it must be paid for at cost ($1). Inventory accounting should be avoided, as single price might be more appropriate to this situation. Even for FPP, you sell software at a percentage of the sale price. In the select area, this is more logical, but in the FPP, it is more of a reverse resale price. Published price list is not the final selling price (as like sticker price on a car, all software prices very). Transfer the good at cost and calculate on a monthly payment. Pay the cost of the CD today and then you pay me a percentage of the price paid later. Task list: item> pricing structure for sale of float stock to FPP.

Two options are sell it all at cost or sell it all at an agreed FPP price.

Data requests, interview list and interview questions: MS Corp

Grace Mac merger could be done in Nevada, and as a contribution, drops down to become subsidiary of MSLI. More substance in GM is better. Eventually wound up into America Cost Share (Nevada).

See "Plan Structure.ppt" for org chart of new structure. See "planstructure.mpp" for information on the timing of events.



Corp – FFP

Non-exclusive Buy-in : Would a third party enter into the deal? It is important that there is a 3rd party element to any agreement made, so exclusive technology rights is important – can't be non-exclusive

Exclusive Future IP cost shared between PR and Corp

New C-Corp needed below MSLI and a drop rights into that company. Would this company be the cost share participant? It should receive both the cost share and the rights.